G. ALLOCATION AND ACCOUNTING REGULATIONS FOR ARBITRAGE BONDS

by
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1. Introduction

Generally, section 103(a) of the Code exempts from Federal income tax the interest on bonds issued by or on behalf of a city, state or other qualifying governmental entity. Section 103(b) provides that this exemption does not apply to any non-qualified private activity bond, any arbitrage bond and any bond that does not meet the requirements of section 149.

To determine the type of bond that is issued and, thus, whether such bond is tax-exempt, it is necessary to examine the issuer's use of the bond proceeds. The use of bond proceeds is a primary factor in determining whether there is compliance with the tax-exempt bond rules. The Code and accompanying regulations provide issuers with detailed guidance for the proper allocation and accounting of bond proceeds. Although the current allocation regulations are found under the arbitrage provisions, the rules are generally applicable to other types of bonds as well, such as private activity bonds and hedge bonds. For the sake of simplicity, though not brevity, this article discusses the allocation and accounting regulations primarily in the context of the arbitrage rules. That stated, before discussing some of the more salient provisions of the regulations, it may be helpful to review some basic arbitrage concepts to place the allocation and accounting rules in context.

2. Arbitrage Basics

The "tax-exempt" status of a section 103 bond is subject to a myriad of rules found in sections 103 and 141 through 150 and the accompanying regulations. Compliance with these provisions, however, has clear practical consequences. Investors are willing to accept lower interest rates on tax-exempt bonds than those offered on taxable bonds because of the tax advantage they receive. In turn, the issuer of tax-exempt bonds obtains a savings by borrowing funds at lower interest rates than available in the taxable market. The "spread" between interest rates on tax-exempt obligations and taxable obligations is often as much as two percentage points.

The spread between tax-exempt and taxable interest rates provides issuers of tax-exempt bonds the opportunity to earn arbitrage. Simply stated, arbitrage is the simultaneous, or nearly simultaneous, purchase and sale of assets in different markets in order to profit from price discrepancies. In the context of tax-exempt bonds, arbitrage is the profit earned by investing the proceeds of tax-exempt bonds in taxable obligations bearing a higher yield. To illustrate this concept, assume a city issues tax-exempt bonds with a 5 percent rate for 30 years. If the city then invests the bond proceeds in taxable obligations paying a rate of 7 percent, the resulting profit is arbitrage.

In the later part of the 1960's, there was a consensus that this and similar type transactions were an abuse of the tax exemption afforded State and local bonds. Congress felt that, unchecked, the spread of arbitrage bonds would pose a threat to Federal Revenues in addition to increasing the financing costs of State and local governments. There was concern that municipalities could potentially saturate the market by issuing unlimited amounts of arbitrage bonds purely for investment purposes, rather than legitimate governmental functions. In response to such concerns, Congress, in 1969, enacted the first legislation restricting arbitrage.

Found in former section 103(c), the first anti-arbitrage provision provided simply that the interest on an arbitrage bond is not tax-exempt. An arbitrage bond was defined, in pertinent part, as any obligation issued as part of an issue all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly-

> (1) to acquire securities or obligations which may be reasonably expected at the time of issuance to produce a yield which is materially higher than the yield on the obligations of such issue, or
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> (2) to replace funds which were used directly or indirectly to acquire securities or obligations described above.

Through former section 103(c), Congress proscribed the issuance of bonds where the issuer's purpose was to invest the bond proceeds in higher yielding investments. Whether a bond was an arbitrage bond depended in large part on the reasonable expectations of the issuer at the time of issuance. Under the language of the statute, the test was fairly straightforward and provided a degree of certainty. If the issuer did not expect at the time of issuance to invest the bond proceeds at a rate of return in excess of the bond yield, the arbitrage analysis was complete and the bond was not an arbitrage bond. Despite the reference only to the issuer's expectations on the date of issuance, it was the Service's position that section 103 also prohibited subsequent intentional acts by the issuer that generate arbitrage. <u>See</u> Rev. Rul. 80-91, 1980-1 C.B. 29.

In addition to the general prohibition on arbitrage bonds, the statute also created exceptions permitting some investment of proceeds at unrestricted yields. For example, proceeds invested for an initial temporary period were not subject to yield restriction. The temporary period was defined as a period of time, for example 3 years, until which the bonds proceeds are needed for the governmental purpose of the issue.

Likewise, the issuer could invest 15 percent of the bond proceeds at an unrestricted yield, either as a minor portion of the proceeds, or as part of a reasonably required reserve or replacement fund. This provided the issuer with a permissible way to invest 15 percent of the bond proceeds in higher yielding investments without running afoul of the arbitrage rules.

Despite the restrictions imposed by the statute, arbitrage persisted. Moreover, the temporary period, minor portion and reasonably required reserve or replacement fund exceptions provided issuers with a license to invest a portion of bond proceeds at unrestricted yield and earn arbitrage. Congress concluded that the presence of arbitrage bonds was still adversely affecting the tax-exempt market. There was a belief that it was necessary to limit the length of time that bond proceeds may be invested at unrestricted yield. In response, the arbitrage rules were substantially revised as part of the Tax Reform Act of 1986.

A. <u>Section 148 of the Internal Revenue Code of 1986</u>

In 1986, Congress replaced sections 103 and 103A of the Code with new sections 103 and 141 through 150 containing provisions applicable to all tax-exempt bonds. The current arbitrage rules are located in section 148 with related provisions in sections 149 and 150.

Section 148(a) of the Code defines an arbitrage bond in essentially the same manner as former section 103(c). Specifically, it is any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly-

> (1) to acquire higher yielding investments, or
>
> (2) to replace funds which were used directly or indirectly to acquire higher yielding investments.

For purposes of section 148(a), a bond is treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue of which the bond is a part to acquire higher yielding investments. Thus, the issuer's reasonable expectations at the time of issuance will not prevent a bond from being an arbitrage bond if the issuer engages in an intentional act after issuance that generates arbitrage.

The enactment of section 148 also brought substantial modifications to the exceptions to yield restriction. For instance, section 148(d) limits to 10 percent the amount of proceeds that may be invested in a reasonably required reserve or replacement fund at unrestricted yield, rather than the 15 percent previously permitted. In addition, the minor portion of proceeds that may be invested in higher yielding investments was reduced to the lesser of 5 percent of the issue proceeds or $100,000 as provided in section 148(e).

B. Rebate Basics

Perhaps the most significant change to the arbitrage rules in 1986, however, was the expansion of the rebate requirement to all tax-exempt bonds.[1] Although the new statute retained exceptions to yield restriction, albeit with modifications, the rebate rule requires that any amounts earned from the investment of gross proceeds at a rate in excess of the rate on the issued bonds must be rebated to the United States.[2] Thus, while an issuer may invest a portion of proceeds at unrestricted yields, the issuer may not retain the net earnings from such investments unless an exception to rebate applies.

The exceptions to rebate are generally classified as either spending exceptions or issuer exceptions. As the name implies, the spending exceptions provide exemptions from rebate where certain proceeds of an issue are expended within certain time periods. For example, section 148(f)(4)(B) excepts from rebate arbitrage earnings on gross proceeds that are entirely expended for the governmental purpose of an issue within 6 months of the date of issuance. Other exceptions include the 18 month expenditure exception and the 2 year construction exception, located in section 1.148-7(d) of the regulations and section 148(f)(4)(C) of the Code, respectively. The rationale behind these exceptions is that limiting the length of time that bond proceeds may be invested at unrestricted yields minimizes potential arbitrage.

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[1] Prior to the 1986 Code, the rebate requirement applied only to bonds issued to finance home mortgages and industrial development.

[2] The rebate requirement is codified in section 148(f). That section provides that a bond shall be treated as an arbitrage bond unless an amount is paid to the United States equal to:

(A) the excess of-

(i) the amount earned on all nonpurpose investments (other than investments attributable to an excess described in this paragraph), over

(ii) the amount which would have been earned if such nonpurpose investments were invested at a rate equal to the yield on the issue, plus

(B) any income attributable to the excess described in subparagraph (A). Pursuant to section 148(f)(3), rebate payments must be made at least once every 5 years during the life of the bond.

Section 148(f)(4)(D) contains an exception for small issuers. Under that section, an issue is excepted from rebate if: (1) the issue is issued by a governmental unit with general taxing powers; (2) no bond which is part of such issue is a private activity bond; (3) at least 95 percent of the net proceeds of such issue are to be used for local governmental activities of the issuer; and (4) the aggregate face amount of all tax-exempt bonds issued by the governmental unit during the calendar year is not reasonably expected to exceed $5,000,000.

Under section 148(f)(2), rebate payments are only required with respect to amounts earned on nonpurpose investments. Earnings on purpose investments are free from the rebate requirement, but not yield restriction. Section 1.148-1(b) defines a purpose investment as any investment that is acquired in order to carry out the governmental purpose of the issue. An example of a purpose investment is a loan made to a 501(c)(3) organization with proceeds of qualified 501(c)(3) bonds. This type of financing arrangement is referred to as a conduit borrowing.

Nonpurpose investments, in contrast, are defined in the negative as any investment property that is not a purpose investment. Though lacking specificity, the term is actually quite broad and encompasses most investment securities, other than tax-exempt securities,[3] in which bond proceeds are invested.

As the arbitrage and rebate rules illustrate, there are numerous restrictions placed on the use of bond proceeds. The Code and accompanying regulations provide detailed rules for the proper allocation of bond proceeds to expenditures. Despite this article's emphasis on arbitrage and rebate, compliance with the allocation and accounting rules is critical for all aspects of tax-exempt bonds. For example, the private activity bond regulations provide that for purposes of section 141, the arbitrage allocation rules apply. Similarly, section 1.149(g)-1(b) provides that the arbitrage and accounting rules under section 1.148-6 also apply to hedge bonds.

3. General Rules for the Allocation of Bond Proceeds

It is the proceeds of a bond issuance that are generally subject to restrictions on usage and investment. Though "proceeds" may refer generally to the funds received from the sale of a bond issuance, this term and several related terms have precise meanings in the context of tax-exempt bonds. A basic understanding of these terms is necessary for applying the allocation and accounting rules.

[3] Section 148(b)(3)(B) provides that investments in tax-exempt bonds subject to the alternative minimum tax are nonpurpose investments if such bonds are acquired with the proceeds of bonds that are exempt from the alternative minimum tax.

Gross proceeds, relevant for arbitrage and rebate purposes, includes proceeds plus replacement proceeds. Proceeds are further defined in section 1.148-1(b) as: (1) sale proceeds, (2) investment proceeds, and (3) transferred proceeds of an issue.

Sale proceeds are defined in section 1.148-1(b) as any amounts actually or constructively received from the sale of the issue, including amounts used to pay underwriters' discount or compensation and accrued interest other than pre-issuance accrued interest. Section 1.148-1(b) defines investment proceeds as any amounts actually or constructively received from investing proceeds of an issue.

Section 1.148-9 provides that transferred proceeds are amounts that transfer from one bond issue to another. If proceeds of an issue, such as a refunding issue, discharge any of the outstanding principal amount of a prior issue, proceeds of the prior issue transfer to the refunding issue and cease to be proceeds of the prior issue.

Replacement proceeds, the second component of gross proceeds, are defined in section 1.148-1(c) as amounts that have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental purpose. An example of replacement proceeds is funds that are pledged by the issuer to pay debt service on the bonds.

Generally, gross proceeds are allocated to an issue and are subject to yield restriction and rebate rules until an event occurs that allocates the proceeds away from the issue, or "deallocates" the proceeds. Under the regulations, amounts cease to be proceeds of an issue when they are allocated to an expenditure for a governmental purpose.

Once an amount of gross proceeds is properly allocated to a governmental purpose expenditure (deallocated), the amount is no longer subject to the yield restriction and rebate rules. Gross proceeds are not deallocated, however, when used to acquire a nonpurpose investment. Such proceeds continue to be subject to yield restriction and rebate.

A. <u>Treasury Regulations</u>

The allocation and accounting regulations are currently located in section 1.148-6. The current regulations contain principles that originated in prior regulations. An overview of the prior regulations will provide some insight to the current rules.

(1) The 1979 Regulations--Section 1.103-13(f)

Section 1.103-13(f)(1) of the 1979 Regulations, adopted with changes as final regulations by T.D. 7627, published on June 7, 1979, was an attempt to solve the specific problem of tracing the proceeds of government issued bonds into acquired obligations.[4] "Specific tracing," matching bond proceeds to expenditures dollar for dollar, provided the most direct method of accounting for proceeds, but was viewed as an administrative burden. The problem was most acute in cases where a municipality issued multiple bonds and there was no requirement under local law or the bond indentures that the issuer separately account for the proceeds of each separate issue. Section 1.103-13(f)(1) attempted to address the limitations of specific tracing by providing that the governmental unit which issues numerous obligations or which commingles the proceeds of bonds with other revenues may allocate acquired obligations to the available proceeds of issued obligations using any method chosen by the issuer.

Section 1.103-13(f)(1) permitted issuers to make allocations "at any time and under any reasonable method," provided that such method of allocation satisfied the following requirements:

a. all allocations had to be consistent with one another;

b. obligations purchased with the original proceeds of a refunding issue had to be allocated to such proceeds;

c. obligations not purchased with original proceeds of a refunding issue may not be allocated to such proceeds;

d. obligations purchased with amounts treated as proceeds under the sinking fund rules of section 1.103-13(g) must be allocated to those proceeds; and

e. if an obligation is allocated to two or more sources of funds, each receipt of principal or interest on the obligation must be allocated ratably among the several sources of funds.

[4] The term "acquired obligations" was defined as securities and other evidences of indebtedness that were not tax-exempt under section 103.

(2) The 1989 Regulations

On May 12, 1989, the Service issued temporary regulations interpreting the rebate provisions of section 148(f). In general, these regulations applied to governmental bonds issued after August 31, 1986, and to private activity bonds issued after December 31, 1985. Section 1.148-4T(a) contained the general rule for the allocation and accounting of investments made with bond proceeds. Specifically, an investment was considered allocated to an issue for the period: (1) that begins on the date gross proceeds are allocated to the issue and to the investment; and (2) that ends on the date such gross proceeds cease to be allocated to the issue or to the investment. Many of the definitions and rules relating to allocation and accounting were reserved in the 1989 regulations, however.

The 1989 regulations also introduced the concept of the universal cap, which, on the most basic level, is a limit on the total amount of proceeds that may be allocated to a bond issue.[5] The 1989 regulations only applied this rule to refunding issues. The Service amended the 1989 regulations on April 25, 1991.

(3) The 1992 Regulations

On May 18, 1992, the Service published final regulations to replace the 1989 regulations.[6] The Service amended the 1992 regulations on September 30 and October 5, 1992. The 1992 regulations addressed issues not fully covered by the 1989 regulations. The allocation and accounting rules found in section 1.148-4 of the 1992 regulations are one such example. Further, as a result of the 1992 regulations, section 1.103-13(f) of the 1979 regulations was withdrawn.

Section 1.148-4(a) provided that an issuer may use any reasonable, consistently applied accounting method to account for gross proceeds of an issue for purposes of section 148. The reasonableness of the accounting method was based on the facts and circumstances. The regulations essentially adopted the rule in the 1992 proposed regulations that required a current outlay of cash and a governmental purpose for any expenditure of gross proceeds. Section 1.148-4(b)(4) also provided that an accounting method may be changed in order to improve the accuracy of the accounting of bond proceeds.[7]

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[5] The universal cap is explained in greater detail below.

[6] The 1992 final regulations were a modified version of three sets of proposed regulations published on January 30, 1992 (section 1.148-4), and February 12, 1992 (sections 1.148-6 and 1.148-11).

[7] The current regulations do not contain a similar provision.

Section 1.148-4(a)(2) of the 1992 regulations also contained an anti-abuse provision for unreasonable accounting methods. That provision provided that an accounting method is not reasonable if it is employed as an artifice or device to avoid the arbitrage provisions.

Under section 1.148-4(b)(3) of the regulations, a "universal cap" was placed on the amount of nonpurpose investments that can be allocated to a particular issue. The limitation equalled the outstanding value of the issue. In other words, if there was $1,000,000 principal outstanding on a bond issue, the amount of nonpurpose investments allocated to that issue could not exceed $1,000,000. Section 1.148-4(b)(3)(vii) also contained an anti-abuse rule that prohibited issuers from allocating investments in such a manner as to avoid application of the universal cap.

(4) The 1993 Regulations

The 1993 regulations were published on June 14, 1993. The Service stated its various goals in the preamble to the regulations: to simplify the arbitrage rules, reduce administrative burdens, clarify the rules on yield restriction and rebate, provide uniform definitions and general anti-abuse rules, clarify ambiguous areas and provide guidelines on previously reserved topics.

The 1993 regulations provide detailed allocation and accounting rules found in section 1.148-6. These rules clarified rules found in the prior regulations. The regulations were amended on May 5, 1994, January 10, 1997 and again on May 8, 1997. The 1993 regulations generally apply to bonds issued after June 30, 1993.

B. Section 1.148-6 (Allocation and Accounting Rules)

(1) General Rule

As discussed above, application of the arbitrage and rebate rules requires a determination as to whether bond proceeds were expended for a governmental purpose or invested. If gross proceeds, for example, are spent for a governmental purpose, then the proceeds are deallocated from the issue and are no longer subject to yield and rebate restrictions. Invested proceeds, however, are potentially subject to both yield restriction and rebate.

Section 1.148-6(a) provides that an issuer may use any reasonable and consistently applied accounting method to account for gross proceeds, investments, and the expenditures of an issue. An issuer may use a different accounting method for a particular item as long as it does so consistently and there is a "bona fide governmental purpose" for using such method.

If an issuer fails to maintain sufficient books and records to establish the allocation of proceeds and accounting method for an issue, section 1.148-6(a)(3) requires use of the specific tracing method. As the term implies, this method requires a direct tracing of bond proceeds to investments and expenditures. As mentioned above, the method often creates an administrative burden for the issuer.[8] This is due to the fact that issuers typically commingle bond proceeds with the proceeds of other issues or other non-bond funds.

(2) One-Issue Rule and Ordering Rules

a. One-Issue Rule

Regardless of the accounting method chosen, gross proceeds are generally allocable to only one issue at a time. Section 1.148-6(b)(1) provides that if amounts are simultaneously proceeds of one issue and replacement proceeds of another issue, those amounts are only allocable to the issue of which they are proceeds.

To better illustrate this rule, if City A issues bonds to advance refund a prior issue and places the proceeds of the refunding bonds in escrow, these amounts constitute sales proceeds of the refunding bonds. However, under the replacement proceeds definition of section 1.148-1(c), these amounts also constitute proceeds of the prior issue. To prevent counting these proceeds twice, the one-issue rule provides that the amounts are allocable only to the refunding issue. In effect, this rule provides that proceeds will not be allocated to two issues simultaneously for purposes of calculating arbitrage and rebate.

The definition of an issue for purposes of sections 103 and 141 through 150 is found in section 1.150-1(c)(1)(i). To determine whether particular bonds are part of the same issue, the following questions must be addressed:

1) were the bonds sold at substantially the same time?

[8] Specific tracing was used in Harbor Bancorp & Subsidiaries v. Commissioner, 105 T.C. 260 (1995), aff'd, 115 F.3d 722 (9th Cir. 1997), cert. denied 118 S.Ct. 1035 (1998). In that case a housing authority issued bonds for the stated purpose of constructing multifamily housing units, a fact indicated in the bond documents. During an unusual closing, and without the knowledge of the issuer, the bond proceeds were diverted and ultimately used to purchase Guaranteed Investment Contracts ("GIC's") to service the debt on the bonds. The housing project was never completed. The Service directly traced the bond proceeds to the purchase of the GIC's. The Tax Court held that the proceeds were used to acquire nonpurpose investments.

2) were the bond sold pursuant to the same plan of financing?

3) are the bonds reasonably expected to be paid from substantially the same source of funds, determined without regard to guarantees from parties unrelated to the obligor?

If the answer to these questions are in the affirmative, then the bonds are part of a single issue and the one-issue rule applies.

There are some instances, however, where bonds that would otherwise comprise a single issue are treated as separate issues. Section 1.150-1(c)(3) provides that if each separate issue finances a separate purpose and would qualify in its own right as a tax-exempt issue, the bonds may be treated as separate issues.

This rule permits an issuer to market two types of bonds together, while treating the bonds as separate issues for tax purposes. The regulations require, however, that the aggregate proceeds, investments, and bonds in such a transaction be allocated between each of the separate issues using a reasonable, consistently applied accounting method. An allocation will not be considered reasonable if it achieves more favorable results than could be achieved with actual separate issues.

b. <u>Deallocating Proceeds</u>

Recall that for purposes of the arbitrage and rebate rules, gross proceeds includes proceeds and replacement proceeds. Thus, applying these rules requires a determination as to when proceeds and replacement proceeds are no longer allocable to a particular issue.

Amounts cease to be allocated to an issue as proceeds or replacement proceeds only:

1) if they are allocated to an expenditure for a governmental purpose;

2) if proceeds, they are allocated to another issue as transferred proceeds, or if replacement proceeds, they are no longer used in a manner that causes those amounts to be replacement proceeds of that issue;

3) by retirement of the issue; or

4) upon application of the universal cap.

Amounts that cease to be allocated to one issue as gross proceeds are eligible for allocation to another issue under section 1.148-6(b)(1).

(3) The Universal Cap

Section 1.148-6(b)(2)(ii) provides the general rule that amounts that would otherwise be gross proceeds allocable to an issue are allocated to the issue only to the extent the value of nonpurpose investments allocable to those gross proceeds does not exceed the value of all outstanding bonds of the issue. For purposes of the universal cap, nonpurpose investments include gross proceeds allocable to cash, tax-exempt bonds that would be nonpurpose investments, qualified student loans, and qualified mortgage loans.

Simply stated, this rule limits the amount of nonpurpose investments allocable to an issue to the value of outstanding bonds. The value of all outstanding bonds is referred to as the universal cap. Therefore, if the value of outstanding bonds is $20,000,000, the amount of nonpurpose investments that may be allocated to the issue is limited to $20,000,000.

If the amount of nonpurpose investments exceed the universal cap, section 1.148-6(b)(2)(iv) provides the rule for deallocating excess amounts. Specifically, that section provides that nonpurpose investments allocable to gross proceeds necessary to eliminate the excess cease to be allocated to the issue, in the following order: (1) replacement proceeds; (2) transferred proceeds; and (3) sale proceeds and investment proceeds.

Since these rules are often difficult to apply in the abstract, the practical effect of the universal cap may best be illustrated with a refunding example. Assume that City A issues bonds to advance refund a prior issue and places the proceeds in a refunding escrow. Assume also that City A uses revenues to establish a reserve fund. Generally, the reserve fund would constitute replacement proceeds of the refunding issue. However, the universal cap prevents allocation of the replacement proceeds (the reserve fund) to the issue until sufficient original proceeds and transferred proceeds have been expended to fall below the universal cap. This rule proves very beneficial where the proceeds of the reserve fund are invested at high yields, which is often the case.

(4) Expenditure Allocations

a. In General

As discussed above, gross proceeds are deallocated from the issue when expended for a governmental purpose, such as the construction of a courthouse, roadway, etc. Such gross proceeds are no longer allocable to the issue and are not subject to rebate or yield restrictions. If the issuer expends gross proceeds for a purpose investment, such as a loan to a conduit borrower,[9] the proceeds are not allocated to an expenditure until the conduit borrower actually spends the money.[10] Even then they remain allocated to the issue as gross proceeds (for yield restriction purposes) until the sale, discharge, or other disposition of the purpose investment.

While this general rule is easy to apply with simple facts, simple facts are the exception, not the rule. Often, an issuer will have several sources of funds available to finance a particular project. The question then becomes how to allocate expenditures to the various sources. Not surprisingly, the regulations also address this question.

Section 1.148-6(d)(1)(i) provides that any of the following methods may be used to allocate funds from different sources to expenditures made for the same governmental purpose, if applied consistently:

(1) Specific tracing. With multiple issues, this would generally require maintaining separate accounts for each issue.

(2) Gross proceeds spent first. This methodology is useful where the issuer has available funds that are not bond proceeds. This permits the issuer to spend the bond proceeds first, thereby reducing arbitrage and rebate liabilities. Compare this to the working capital expenditures rule discussed below.

(3) First-in, first-out. Where there is more than one bond issue, this method would permit the issuer to treat the proceeds of the first issue as first spent, the proceeds of the second issue next, and so on.

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[9] In a conduit borrowing, the proceeds of the bonds are not used by the governmental issuer, but rather by a private entity such as a 501(c)(3) organization.

[10] The general rule does not apply if the purpose investment is with respect to a qualified mortgage bond or a qualified student loan bond issue. In these cases the expenditure is deemed made at the time the issuer acquires the purpose investment. Nevertheless, the proceeds continue to be allocated to the issue for yield restriction purposes until the purpose investment is sold, discharged, or otherwise disposed of.

(4) Ratable allocation method. Rather than maintaining separate accounts for multiple issues, the issuer places all proceeds in a single account. Proceeds are de-allocated proportionately to each issue as expenditures are made.

Regardless of the accounting method, any allocation of gross proceeds to an expenditure, requires a current outlay of cash. The issuer must reasonably expect this outlay of cash to occur not later than 5 banking days after which the allocation of gross proceeds to expenditures is made.

Further, section 1.148-6(d)(iii) provides that an issuer must account for the allocation of proceeds to expenditures not later than 18 months after the later of: (1) the date the expenditure is paid or (2) the date that the project that is financed by the issue, if any, is placed in service. In any event, the allocation must be made within 60 days after the fifth anniversary of the issue date or, if earlier, 60 days after the retirement of the issue.[11]

b. Working Capital Expenditures

Working capital expenditures are defined in section 1.150-1(b) as any cost that is not a capital expenditure.[12] Current operating expenses of a municipality are an example of working capital expenditures.

In keeping with the general policy of limiting the issuance of bonds until the proceeds are actually needed for a governmental purpose, the regulations create a restrictive allocation rule for working capital expenditures. Section 1.148-6(d)(3)(i) provides that proceeds of an issue may only be allocated to working capital under a "gross-proceeds-spent-last" method.

Under this rule, the issuer may not allocate proceeds to working capital expenditures until other amounts are unavailable to the issuer. For purposes of this rule, available amounts include cash, investments, and other amounts held in accounts or otherwise by the issuer that may be used for working capital expenditures without legislative or judicial action. Section 1.148-6(d)(3)(i) treats reasonable amounts in a working capital reserve as unavailable. Such reasonable reserve, however, is not to exceed 5 percent of the actual working capital expenditures of the issuer in the preceding year.

[11] Note that section 1.148-6(d)(iii) applies only to bonds issued on or after May 16, 1997.

[12] This definition applies for all purposes of sections 141 through 150.

The effect of this rule is clear. Since gross proceeds remain allocable to the issue until other funds are unavailable, the proceeds remain subject to the arbitrage and rebate rules for a longer period of time. This limits the issuer's incentive to finance normal operating expenses with tax-exempt bonds while investing the proceeds of the bonds or other amounts on hand in higher yielding instruments.

c. Purpose Investment Expenditures

As mentioned above, a purpose investment is any investment that is acquired in order to carry out the governmental purpose of the issue. The example provided was that of a loan to a 501(c)(3) organization. In such a situation, the recipient of the loan, or the obligor, is referred to as a conduit borrower.

Under section 1.148-6(d)(2), the issuer does not allocate gross proceeds to an expenditure until the conduit borrower properly allocates the gross proceeds to an expenditure. Therefore, the gross proceeds remain subject to yield restriction and rebate until spent by the conduit borrower. This imposes a continuing obligation on the issuer to monitor the disposition of the proceeds.

Note that the general rule stated above does not apply to qualified mortgage loans and qualified student loans. Pursuant to section 1.148-6(d)(2)(ii), if gross proceeds are allocated to either a qualified mortgage loan or a qualified student loan, those gross proceeds are allocated to an expenditure on the date which the issuer allocates gross proceeds to that investment. Typically, this is the date that the issuer uses proceeds to either make or purchase these type of loans.

d. Commingled Funds

Under section 1.148-1(a), a commingled fund means any fund or account that contains both gross proceeds of an issue and amounts in excess of $25,000 that are not gross proceeds of the issue. As mentioned above, issuers frequently commingle gross proceeds of an issue with other funds. This is done to invest the funds more efficiently.

Section 1.148-6(e) imposes special accounting rules for commingled funds. Specifically, subparagraph (2) of that section requires all payments and receipts with respect to investments in a commingled fund to be allocated to each investor at the close of each fiscal year using a "consistently applied, reasonable ratable allocation method." To illustrate, if the issuer commingles funds, it cannot simply allocate any lower yielding investments to the gross proceeds portion of the funds without allocating a ratable portion to the other sources of funds.

For purposes of this rule, the term investor means each different source of funds. For example, if a city invests gross proceeds of an issue and tax revenues in a commingled fund, it is treated as two investors.

e. Reimbursement Allocations

A reimbursement allocation is an allocation in writing that evidences an issuer's use of bond proceeds to reimburse an expenditure that was previously paid from sources other than the bond proceeds. For example, if City A spends $5,000,000 from its general funds on May 1, 1998, in connection with the construction of a courthouse, it may issue $5,000,000 of bonds on January 1, 1999 and allocate the gross proceeds to the prior expenditure. If the reimbursement is proper, City A may invest the gross proceeds of the bonds without arbitrage consequences.

In allocating gross proceeds of reimbursement bonds, section 1.148-6(d)(5) states that the rules of section 1.150-2 apply.[13] Section 1.150-2(d) provides the general operating rules for reimbursements. Essentially, bonds will be respected as reimbursement bonds if three requirements are met. These requirements relate to (1) official intent; (2) the reimbursement period; and (3) the nature of the expenditure.

Pursuant to section 1.150-2(d)(1), not later than 60 days after payment of the original expenditure, the issuer must adopt a reasonable intention to reimburse the expenditure with gross proceeds of a bond issuance. Section 1.150-2(e)(2) further provides that the declaration must describe the project for which the expenditure is paid and state the maximum principal amount of bonds expected to be issued for the project.

The second requirement is that the reimbursement allocation must be made not later than 18 months after the later of (1) the date the original expenditure is paid; or (2) the date the project is placed in service or abandoned, but in no event more than 3 years after the expenditure is paid.

Finally, the nature of the expenditure must be of the type permitted by section 1.150-2(d)(3). Generally, reimbursements are permitted only for the following expenditures: capital expenditures; certain extraordinary working capital expenditures incurred before issuance of the reimbursement bond; costs of issuance; a grant; a qualified student loan; a qualified mortgage loan; or a qualified veterans' mortgage loan.

[13] If, however, the gross proceeds are used to reimburse a working capital expenditure, as discussed above, the rules of section 1.148-6(d)(3) apply.

When examining these transaction, it is important to note that a reimbursement allocation has substance that must be respected by the issuer. In PLR 9723012, an issuer requested a ruling on whether it could reallocate, after issuance, bond proceeds to a permissible expenditure, despite the fact that the bond documents allocated the proceeds to an impermissible expenditure.

The issuer argued that its original allocation to an impermissible expenditure "exists only on paper." Reallocating the proceeds to a permissible expenditure, it argued, would not change the substance of the transaction. Rejecting this contention, the Service ruled that a reimbursement does, in fact, have substance that cannot be disregarded. Although the issuer was not satisfied with the consequences of the allocation, it chose it. The Service ruled that the latest date for which an allocation of expenditures can be made is the issue date of the bonds, or perhaps a reasonable period of time thereafter.

4. The Anti-Abuse Regulations

In general, the 1993 regulations are simpler than earlier regulations because they rely more on a subjective rule that issuers of tax-exempt bonds may not employ an abusive arbitrage devise. An abusive arbitrage devise is a transaction that complies with the letter of the law, but not its spirit. While the 1979 regulations provided a similar rule, the 1993 regulations take a new approach in using general anti-abuse language instead of creating specific rules.

Section 1.148-10(a)(2) defines an abusive arbitrage devise as an action that enables the issuer to exploit the difference between taxable and tax-exempt interest rates to gain a material financial advantage and overburdens the tax-exempt bond market. The regulation provides that exploitation of interest rates may be found, even though the issuer does not invest bond proceeds at a higher rate for the entire life of the issue. An action overburdens the market if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is "otherwise reasonably necessary to accomplish the governmental purposes of the bonds, based on all the facts and circumstances."

5. Conclusion

As this article attempted to stress, the issuer's use of bond proceeds is critical in determining whether there is compliance with the tax-exempt bond rules. The current allocation and accounting regulations attempt to provide a workable approach to account for expenditures and prevent abuses of the tax-exempt market. The regulations found in section 1.148-6 provide guidance not only with respect to arbitrage and rebate issues, but with other types of bonds as well, including private activity bonds and hedge bonds. Failure to comply with the Code and applicable regulations may result in the payment of rebate by the issuer or a determination that interest on the bonds is not tax-exempt.